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¶1. (SBU) Summary. On February 6, Embassy hosted a Roundtable on Electricity Regulation in Brazil with participation by 16 executives from 8 U.S. and European companies from both the generation and distribution sides. Companies' main concerns were short-term liquidity issues, continued low electricity demand, and the upcoming periodic review of tariff rates. Companies were clearly anxious over the new GoB's impending reformulation of sector regulation, and most attendees noted that their companies have halted further investments in Brazil pending the emergence of a clear regulatory model. Nonetheless, all company representatives termed their access to GoB officials as "good" and their initial impressions of Minister of Mines and Energy (MME) Dilma Roussef as positive. Groundwork was laid for a continuing dialogue between the private sector and the Mission. End Summary.

¶2. (SBU) As part of a mission-wide strategy to coordinate our policy approach in Brazil's energy sector, on February 6 the Ambassador hosted a diverse group of electric utilities including U.S. companies Alliant, Duke, Enron, AES, Mirant, and PSEG, as well as European companies EDP (Portuguese), and Tractebel (Belgian). Grupo Cataguazes (Brazilian) and Endesa (Spanish) were last minute no-shows. Ambassador and CG Rio had already hosted a similar event for hydrocarbon companies in ConGenRio during the last week of January (ref A). Ambassador and CGs have also been meeting frequently with U.S. companies on a one-on-one basis. Econ and commercial officers followed-up the February 6 roundtable by making a courtesy call on MME Secretary for Energy Marcelo Poppe. Ambassador expects to make her initial call on Roussef during the week of February 24.

Background to a Mess

¶3. (U) The timing and concerns of the roundtable reflect the current confusion and uncertainty surrounding the electricity sector. In the mid-90s, the Cardoso administration embarked on an ambitious privatization program to attract much-needed investment to the state-dominated energy sector. The process was poorly implemented from the start, as Congress failed to pass comprehensive sector reform legislation similar to that created for the telecommunications sector via the General Law of Telecommunications. Instead, Congress carried out the process piece-meal. Congress first legalized the sale of states' distribution companies. In 1995, Espirito Santo sold its distribution company ESCELCA to a group of foreign investors. U.S. companies, led by AES, began investing in ¶1996.

¶4. (U) Reform legislation continued to trickle through Congress, resulting in the creation of the national electricity regulator ANEEL in 1997, and the creation of the wholesale energy market (MAE) in 1998. Although the National Council for Energy Policy (CNPE), a committee within the MME, was given responsibility for long-term policy planning, the weakness of the MME as an institution encouraged ANEEL to step into the policy realm and complete the sector reform process de facto through regulation. CNPE has met only three times to discuss long-term policy. Roussef has commented on various occasions that the MME will "recapture the policy role" from ANEEL.

¶5. (U) Devaluation at the beginning of 1999 presented the first warning signal for foreign companies whose debts were dollar-dominated, but whose revenue streams were in Brazilian reals. Since 1999 the dollar has appreciated approximately 200 percent in nominal terms against the real. For distribution companies, this has been partially compensated by annual GoB tariff adjustments based on a broad-based inflation index -- 87 percent over the same period. Currency risk has also put a damper on thermal-generation investment, as the cost of turbines, fuel, and natural gas are dollar-linked.

¶6. (U) The privatization process met growing political

resistance in 2000 when the government's plan to privatize state generator giant FURNAS faltered amidst popular discontent. The process then stalled-out completely with the electricity shortage and subsequent government-mandated rationing in 2001. Although the outgoing government received high marks for managing the rationing crisis, it was unable to make progress on a comprehensive reformulation of the regulatory model, leaving this major headache for the new government.

¶7. (U) The GoB also failed to provide permanent fixes to institutions such as the MAE (see ref C), the CNPE, and ANEEL. Although the GoB ended rationing in February 2002, deleterious after-effects continue to affect generators and distributors as electricity end-users have rolled back their consumption to 1999 levels. Lower demand, combined with abundant rains that have filled reservoirs in Brazil's 90 percent hydro-dominated system, has led to an electricity surplus depressing spot prices to their regulated price floor - approximately 1.15 dollars per megawatt hour. This is unfortunate timing as a pre-planned phased liberalization of the market freed 25 percent of the market's bilateral electricity contracts held between generators and distributors on January 1, 2003. This electricity, estimated to be between 3,500 to 5,000 megawatts of capacity, remains unsold. Generators have begun to assert that the government, or distributors, must find a way to share the pain for the depressed prices.

¶8. (U) In summary, the new government of President Lula has inherited an electricity sector mess. Dollar-linked debt, depressed supply prices, institutional gridlock, macroeconomic constraints (i.e., inflation-target and fiscal-surplus limits), and the supposed left-leaning platform on which the new government rode into power all raise doubts among investors for the long-run viability of the electricity sector.

¶9. (SBU) In addition to putting out some of the fires above, the new government must now define a sector model, principally deciding what role private finance, current and future, will play. Roussef, a former 1970s guerilla (ref B), spent the first month putting her team together, and from all accounts is serious, frank, and intelligent. Despite these positive attributes, industry anxiety regarding her plans for the sector and the outcome of the new model is running high.

Distributors Focus on Tariff Reviews

¶10. (U) Not surprisingly, distributors at the roundtable seemed most focused on short-term issues. First on their mind was this year's periodic tariff reviews, which are conducted every four to five years depending on the date of each distributor's concession contract. This year, ANEEL will conduct 17 tariff reviews with the goal to restore "financial equilibrium" to distributors, and split productivity gains between distributors and consumers. During the event distributors lamented that financial equilibrium remains an undefined term.

¶11. (U) In November 2002, ANEEL announced it would use companies' current asset values as the basis for calculating the capital value of each distributor, a key component in the methodology for conducting the 2003 tariff reviews. This announcement came as a surprise to industry as the GoB had used an altogether different basis to determine the capital value of each distributor when seeking minimum bid prices during privatization in the late 90s. During that period, ANEEL determined the capital value of the company on the projected discounted revenue stream of the distributor.

¶12. (U) ABRADEE (the primary distributors' association in Brazil) immediately objected to ANEEL's proposed use of current asset value to determine capital value, and has since led the charge against its implementation. ABRADEE asserts that the depreciation in the Brazilian real since 1998 has eroded the asset value of sector companies, and that the use of this methodology would result in an insufficient increase in tariffs. ABRADEE has proposed instead that the capital value of the company be computed as it was for the minimum bid prices used during privatization. An estimated 26 billion reals over the next five years industry-wide are in play in this decision that will lead to either an average 20% to 25% tariff increase, if ANEEL's methodology is used, or an average 40% increase, if ABRADEE's is.

¶13. (U) ABRADEE has already been dealt an initial defeat as two successive federal judges have declined the association's request for an injunction on the current tariff reviews. On February 17, ANEEL released its formula for the first three reviews for public comment. The agency also stated that distributors receiving high tariff adjustments following the review would have them implemented in "parcels", starting this year and continuing into the future in order to lessen the impact on consumers.

Short-term Liquidity Crunch

¶14. (SBU) For some distributors, short-term liquidity problems rank ahead of tariff concerns. AES, for example, has a total Brazil-related debt running into the billions, with a large percentage of it short-term and dollar-linked. With a depreciated real and 1999 levels of electricity demand, AES simply cannot make the receipts to cover its debt. The company also continues to experience large losses from municipal government non-payment. AES told Ambassador in a private meeting that municipalities owe 400 million reals to AES distributor Eletropaulo alone.

¶15. (SBU) Distributors told us that short-term fixes, i.e., 90-day debt rollovers, are not helpful, and that most important is GoB acceptance of companies' rights to a reasonable level of return. One of their suggestions is to increase tariffs on industrial consumers. Currently, Brazil's residential consumers pay rates several times that of industrial consumers. While such increases may seem, at first glance, more politically acceptable to the new left-leaning GoB than increasing the electricity bill of the average consumer, roundtable participants told Embassy officers that the GoB was not likely to increase rates on industrial consumers for fear of reducing their own campaign funds.

¶16. (SBU) Another option highlighted was a reduction in taxes. Distributors commented that approximately 27 percent of consumers' electricity bills are tax. The great majority of this is ICMS, a state tax. Distributors told us that the corresponding tax burden in the United States was about six to seven percent. However, roundtable participants were pessimistic on the prospects of the GoB reducing taxes.

Generators Not Overly Concerned by Single-Buyer Concept
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¶17. (U) As mentioned above, government-mandated rationing, abundant rains, and the phased liberalization of 25 percent of bilateral electricity contracts has depressed wholesale electricity prices. A longer-term problem facing the government is how to diversify Brazil's electricity mix. The majority of policy-makers concede that some non-hydro generation is desirable to avoid dramatic fluxes as seen during the 2001 drought when dry reservoirs in three out of Brazil's four regions combined with inadequate transmission infrastructure to push prices to 650 reals per megawatt on the spot market. However, new thermal plants with higher amortization and fuel costs simply cannot compete with older hydro plants in normal conditions.

¶18. (U) One idea for dealing with price fluctuations and creating incentives for future generation investment is MME's vaguely stated proposal to create a single buyer to trade energy between a pool of generators and individual distributors. Theoretically, such a trader would pay thermal generators higher prices than amortized hydro plants, thus arriving at an unified average cost of energy. This would maintain profitability for thermal generators who face difficulties covering their costs when abundant rains make hydro cheap. Going into the roundtable, we had expected to hear vehement industry objections to this proposal, but were surprised to see generally neutral attitudes on the subject. More GoB specifics on this proposal should emerge in upcoming months.

Opinions on Current Government Guarded; Access to GOB Good
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¶19. (SBU) Companies told Ambassador that their access to the new government has been "good." They report that Roussef appears to be direct, strong-willed, and opinionated, but also fair and intelligent. This echoes what we've been hearing in private one-on-one meetings with U.S. companies, and reinforces the commonly-held notion that it was Roussef's drive that achieved the partial resolution wholesale electricity market (MAE) accounts in early January. Roussef spent most of her first four weeks in office placing trusted advisors in key positions throughout the energy sector. Now that her team is built, Roussef appears to be moving directly to reformulation of the electricity sector model. A Brazilian weekly quipped that if the GoB followed the McDonald's best practices, Roussef would be "Minister of the Month."

¶20. (U) Diligent performance in her first 30 days has raised industry expectations of Roussef's capabilities, as well as industry hope that the GoB "shares the pain." The GoB does indeed appear willing to accept that it has some responsibility toward finding a solution for the sector crisis. In a February 6 meeting with econoff and commercial officers, Secretary for Energy Marcelo Poppe said the MME has formed a working group to present a reformulated model by July, with a period of public comment to follow. A report in national daily Estado de Sao Paulo on February 13 quoted MME Executive Secretary Mauricio Tolmasquim as saying that the MME would introduce a package of refinancing intended to

assist companies to survive until the new model is implemented sometime near the end of the year.

Conclusion and Comment

¶21. (SBU) The future role of private finance in the Brazilian electricity sector is unclear, and likely to remain so until at least July. The GoB has already said its future model will be a mixed model of public and private investment. It may be that the future MME plan will trade large potential profits, private investment, and efficiency gains for a less efficient, but more stable sector with lower returns. Eletrobras President Pinguelli Rosa has been quoted as saying 15 to 20 percent returns are "unrealistic," and praised the French system as more reliable with 5 to 10 percent returns.

¶22. (SBU) Pending the new model's definition, the GoB must find a way to deal with distributors' short-term liquidity problems. Many of these private investors are requesting that the government (i.e., development bank BNDES, Eletrobras, and the state generators) "take a haircut" on a portion of the distributors' outstanding debts, some of which predate privatization. However, convincing the current GoB to write down debts created by its predecessor is an unlikely prospect. Eletrobras has its own stockholders who will balk at big bailouts, and though new BNDES President Carlos Lessa originally called his organization a "hospital for sick companies," his sentiment has been publicly rebutted by Minister of Finance Antonio Palocci.

¶23. (SBU) The primary alternative to refinancing deals is reversion of concessions to the GoB. Such a move would result in long legal challenges, and one also wonders if the GoB would really wish to manage these utilities. Our earliest indications are that Roussef herself, despite her original extreme-left ideology, now does not want to "refederalize" companies.

¶24. (SBU) Mission will continue to engage U.S. business, and maintain open dialogue with the GoB as it formulates its model. We will lend support to ABRADEE's proposal for tariff revision methodology, and urge options to improve companies' financial health while limiting cost increases to residential consumers. GoB options, in this context, include urging local governments to pay up, reducing taxes on electricity, and redressing the imbalance between residential and industrial tariffs. Over the longer-term we will seek opportunities to strengthen institutions such as ANEEL and the MAE, and promote cooperation between policy planning organizations such as the Brazilian CNPE (National Council for Energy Policy) and the United States Energy Information Administration.

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